In the Supreme Court of the United States

OCTOBER TERM, 1964

No. ——

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FENDER SALES, INCORPORATED

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

This is a conditional cross-petition. The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in this case in favor of Fender Sales, Incorporated, but only if the Court grants the petition for a writ of certiorari filed by Donald D. and Jean E. Randall, *et al.*, in a companion case, No. 1053.[1]

[1] *Donald D. Randall and Jean E. Randall, Esther Fender, Jean E. Randall, Donald D. Randall, C. Leo Fender v. Commissioner of Internal Revenue*, October Term 1964, No. 1053. Donald D. Randall and C. Leo Fender are the parties in interest; their wives are parties by virtue of the filing of joint income tax returns. The cases of these petitioners were consolidated in the Tax Court and in the court of appeals with that of Fender Sales, Incorporated; all arose out of one set of facts.

772-175—65

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 1–36)[1] is not officially reported. The opinion of the court of appeals (Pet. App. 37–59) is reported at 338 F. 2d 924.

JURISDICTION

The judgment of the court of appeals was entered on December 1, 1964.[2] By order dated March 2, 1965, Mr. Justice Douglas extended the time for filing a petition for certiorari to and including April 30, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

The court of appeals held that Fender and Randall, the sole and equal stockholders of Fender Sales, Incorporated, realized taxable income when salary obligations owed them by Fender Sales and deducted by it in earlier years were discharged through the issuance to Fender and Randall of common stock of the corporation. The court further held that the corporation realized no income in the transaction. The question is whether, if the court of appeals erred in holding that Fender and Randall realized income, it also erred in not holding that the corporation realized taxable income.

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[1] "Pet. App." references are to the appendix to the petition for certiorari filed by Donald D. and Jean E. Randall, *et al.* in the companion case (No. 1053).

[2] The appendix to the petition for certiorari in No. 1053 does not print any of the six judgments in the consolidated cases in the court of appeals. We print the judgment in favor of the corporation, from which we take this conditional petition, in the appendix to this petition, p. 9, *infra*. The five judgments in favor of the government, from which the petition in No. 1053 is taken, were entered on the same day and are similar in form.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * * *

(12) Income from discharge of indebtedness;

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[26 U.S.C. 61.]

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.61–1 GROSS INCOME.

(a) *General definition.*—Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. * * *

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[26 C.F.R. 1.61–1.]

SEC. 1.61–2. COMPENSATION FOR SERVICES, INCLUDING FEES, COMMISSIONS, AND SIMILAR ITEMS.

* * * * *

(d) *Compensation paid other than in cash.*—(1) *In general.* If services are paid for other

than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. * * *

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(4) *Stock and notes transferred to employee* * * * * * * if a corporation transfers its own stock to an employee * * * as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee * * * * * *

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[26 C.F.R. 1.61-2.]

STATEMENT

Fender and Randall owned all of the common stock (the only type of stock issued) of Fender Sales, Incorporated. They each owned 50 shares, with a par value of $100 per share. Fender and Randall were employed as officers of Fender Sales, at annual salaries of $15,000 (Pet. App. 38).

Fender Sales, which followed the accrual method of accounting for federal income tax purposes, accrued and deducted the salaries of Fender and Randall each year for its fiscal years 1954, 1955, 1956, and 1957 (a total of $60,000 salary for each man) but did not pay these salaries to Fender and Randall. Fender and Randall, on the cash basis of accounting for federal income tax purposes, did not report these

salaries on their federal income tax returns (Pet. App. 39–41).

To comply with a request of the corporation's lender-bank that the salary liability to Fender and Randall be capitalized, Fender and Randall offered to receive one share of $100 par value common stock of Fender Sales for each $100 of salary owed them. The offer was accepted by Fender Sales and the stock issued (600 shares of $100 par value common stock to each man). As a result, Fender Sales' capital stock account was increased by $120,000 and the $120,000 salary liability was discharged and cancelled (Pet. App. 38–40).

The Commissioner of Internal Revenue asserted tax deficiencies against Fender and Randall, and Fender Sales alternatively. The commissioner took the position that the receipt of the stock by Fender and Randall constituted taxable salary income to them, but that, if it did not, then Fender Sales realized taxable income as a result of the cancellation of the salary indebtedness. The Tax Court (Pet. App. 1–36) held that neither Fender and Randall nor Fender Sales had realized income. The Commissioner appealed to the Court of Appeals for the Ninth Circuit, contending that Fender and Randall had realized income, but if not (and only if not), then Fender Sales had. The court of appeals (Pet. App. 37–50), Judge Barnes dissenting (Pet. App. 50–59), agreed that Fender and Randall realized income in the transaction and reversed the Tax Court as to them. The court further held that Fender Sales had not realized any income and dismissed the Commissioner's petition

for review as to it. Fender and Randall have filed a petition for a writ of certiorari (No. 1053).

REASON FOR GRANTING THE WRIT

This is a conditional cross-petition. We ask that this petition be granted only if the Court grants the petition of Fender and Randall, which we oppose. As will be fully explained in our separate response to the latter petition, we think the court of appeals was correct in holding that Fender and Randall realized income in the transaction and that Fender Sales did not. This was our primary position in the court of appeals. However, in our view, if Fender and Randall did not receive income, Fender Sales did. This was our alternative contention in the court of appeals and it is the position we seek to protect by this petition.

The only way in which Fender and Randall can escape income taxation here is to show that they received or realized nothing from the corporation through the issuance of stock to them in return for the cancellation of salary liability. If that were true, it would follow that the corporation paid out nothing to Fender and Randall. Nevertheless, as a result of the transaction, the corporation's salary liability to Fender and Randall was discharged. The corporation had accrued deductions for this salary liability in earlier years, when the salaries were not paid. If the salary liability is to be cancelled without a corresponding payment by the corporation, those previous deductions must be restored to income. Otherwise, the corporation would receive the benefit

of deductions from income for amounts never paid and never to be paid, thus permitting it to accumulate tax-free income. Therefore, if taxable income is not to be attributed to Fender and Randall, we submit that such income must be attributed to the corporation.

CONCLUSION

In our view, either Fender and Randall or Fender Sales realized income as a result of these events. If the court of appeals' determination concerning Fender and Randall is to be reviewed, its determination regarding Fender Sales should be reviewed at the same time in order to prevent taxable income from escaping taxation entirely. We respectfully submit that this petition for certiorari should therefore be granted if the petition of Fender and Randall is granted.

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APRIL 1965.

APPENDIX

United States Court of Appeals for the Ninth Circuit

No. 19074

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

FENDER SALES, INC., RESPONDENT

JUDGMENT

Upon Petition to Review a Decision of The Tax Court of the United States

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the petition to review the Decision of the said Tax Court of the United States in this Cause be, and hereby is dismissed.

Filed and entered December 1, 1964.

U.S. GOVERNMENT PRINTING OFFICE: 1965